Internal Revenue Service

memorandum

TL-N-4237-91
CC:TL:TS/P-TJKANE

date: APR 23 1991

to: District Counsel, Manhattan CC:NA:MAN
Attn: Roland Barral

from: Chief, Tax Shelter/Partnerships Branch

subject: [redacted]

This is in response to your memorandum dated February 26, 1991, requesting written advice on several issues arising under sections 731 and 751 of the Internal Revenue Code.

ISSUES

Although your request does not delineate the specific issues to be addressed, a review of the file materials and discussions with your office have resulted in our identifying the following issues for consideration:

(1) How are the government securities, equities and options ("financial positions") of [redacted] ("Partnership"), a broker-dealer, categorized for purposes of I.R.C. § 751?

(2) What is the relationship between I.R.C §§ 351 and 751 with respect to the exchanging partners of the Partnership?

(3) As a result of the technical termination of the Partnership, what is the proper relationship between I.R.C. §§ 708, 731, and 751 with respect to the new and continuing partners of the Partnership?

(4) What is the proper method of computing the gain, if any, that should have been recognized as a result of the [redacted], exchange?

(5) Is there any alternative method of challenging the [redacted] transaction?

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CONCLUSIONS

(1) We agree that the financial positions of the Partnership can be categorized as unrealized receivables for purposes of I.R.C. § 751.

(2) The nonrecognition provisions of I.R.C. § 351(a) generally override the realization provisions of I.R.C. § 751. However, as *to the exchanging partners of the Partnership, when there is gain* recognized under I.R.C. § 351(b), I.R.C. § 751 will operate to characterize any recognized gain as ordinary income to the extent provided under such Code section. The exchanging partners are subject to certain compliance requirements under Treasury Regulation § 1.751-1(a)(3).

(3) Upon a technical termination of a partnership under I.R.C. § 708(b)(1)(B), as to the new and remaining partners of the Partnership, and under given facts and circumstances, I.R.C. § 731 controls, and the recharacterization provisions of I.R.C. § 751(a) do not apply.

(4) With the issues as they are presently framed, it would appear that the manner, method and amount of gain calculated by the taxpayers in their submission dated [redacted], is correct.

(5) It is possible that the incorporation transaction might be attacked by challenging the business purpose underlying the incorporation, or by using a sham or step-transaction analysis.

As to issues 2 and 3, as discussed more fully below, the language of the FPAA may be inartfully worded. However, as evidenced by the file materials accompanying your request, it appears that the parties are generally focused on the correct issues, although an early clarification would be in order.

FACTS

The Partnership was originally formed in [redacted] to act as a broker-dealer. In [redacted] and [redacted] the Partnership had over [redacted] limited partners and reported substantial ordinary tax losses for each year (which have been disallowed on examination). On [redacted], the Partnership technically terminated when most of the limited partners of the Partnership (other than certain limited partners who were also employees of the partnership) transferred their partnership interests to a newly formed holding company, [redacted], in an incorporation transaction that was intended to qualify as a tax free exchange under I.R.C. § 351. At the same time, several general partners also transferred part or all of their partnership interests to [redacted] as part of the incorporation transaction.

DISCUSSION

Preliminarily, it is noted that the adjustments under I.R.C. § 751(a) and (b) are partnership items. _See_ Treas. Reg. § 301.6231(a)(3)-1(a)(1)(vi)(E). Also, the discussion that follows is premised on the assumption that the broker-dealer activities of the Partnership cause the Partnership gains to be characterized as ordinary income.

Issue 1

With respect to the issue regarding I.R.C. § 751, the first concern that must be addressed is whether the financial positions in question are I.R.C. § 751 property ("hot property"). For purposes of I.R.C. § 751, hot property consists of (1) unrealized receivables of a partnership, or (2) inventory items of a partnership which have appreciated substantially in value. I.R.C. § 751 is intended to prevent the use of the partnership vehicle to artificially convert what would otherwise be ordinary income from hot property into capital gain.

As a result of the operation of I.R.C. § 751, if a partnership holds hot property, then

(1) under I.R.C. § 751(a), an exchange by a partner of a partnership interest for consideration, and

(2) under I.R.C. § 751(b), certain disproportionate distributions of partnership property to a partner in exchange for all or part of his interest in partnership property

will result in either the recognition of ordinary income instead of capital gain (in exchange transactions) or gain recognition when none may have otherwise occurred (in certain distribution transactions). Thus, I.R.C. § 751 overrides the provisions of I.R.C. § 741, which ordinarly characterizes the gain or loss on the sale or exchange of a partnership interest as capital in nature, and the provisions of I.R.C. § 731, which would otherwise limit recognition of any such gain or loss.

I.R.C. § 751(c) defines "unrealized receivables" to include, in part, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset. I.R.C. § 751(d) defines inventory items to include, in part, partnership property of the kind described in I.R.C. § 1221(1) and any other partnership property which would not be a capital asset or I.R.C. § 1231 property if sold or exchanged. Inventory items will be considered to be appreciated substantially in value if their fair market value exceeds 120 percent of their adjusted basis to the partnership and exceeds 10 percent of the fair market value of all partnership property.

The Notice of Final Partnership Administrative Adjustment ("FPAA") has characterized the financial positions as unrealized receivables, instead of inventory, for purposes of I.R.C. § 751. The revenue agent indicates that the reasons for this characterization were:

(1) the financial positions are not true inventory items;

(2) the 120 percent test could not be met if the financial positions are considered to be inventory items; and

(3) the deferred income and gains inherent in the financial positions were "locked in" (as is often the case with these issues), thereby truly representing deferred unrealized receivables.

The regulations under I.R.C. § 751 contain a nonexclusive listing of what can constitute unrealized receivables and inventory items. _See_ Treas. Reg. §§ 1.751-1(c) and (d), respectively. With respect to unrealized receivables, Treas.

Reg. § 1.751-(c)(1) states, in part, that the term means any rights (contractual or otherwise) to payment for goods to be delivered (to the extent that such payment would be treated as received for property other than a capital asset). The term "goods" is not more specifically defined, and research on this issue has not uncovered any definitive guidance in this area relative to your facts. (Most of the case law in this area deals with the typical accounts receivable issues and long term contract issues). However, given your facts and background analysis, there is analogous support for your position regarding your unrealized receivables characterization. Because the nature and extent of the gain or profit inherent in the financial positions was essentially locked in prior to [redacted], the Partnership is essentially in no different position than the partnerships were in Hale v. Commissioner, T.C. Memo. 1965-274 (partnership's contractual right to future income based upon providing future services was held to be unrealized receivables under I.R.C. § 751 for purposes of recharacterizing the gain of a withdrawing partner), and Ledoux v. Commissioner, 77 T.C. 293 (1981), aff'd, 695 F.2d (11th Cir. 1983)(upon the sale of his partnership interest to his other partners, I.R.C. § 751 applied to a portion of the gain realized by the selling partner that was attributable to a management contract to perform services and earn ordinary income in the future because the management contract qualified as an unrealized receivable).

Given (1) the purpose underlying I.R.C. § 751, (2) that unlike the cases cited above, nothing more than the mere passage of time will be needed in order for the gain to be recognized to the Partnership, and (3) the broad, nonexclusive definition of what constitutes an unrealized receivable for purposes of I.R.C. § 751, we agree with your conclusion that the financial positions in question qualify as unrealized receivables for purposes of I.R.C. § 751.

We note, however, that an argument could be made, under the appropriate circumstances, that the financial positions at issue constitute inventory items of the Partnership, and could be the principal argument given the right set of facts. This is because the definition of "inventory items" contained in I.R.C. § 751(d)(2), as indicated above, is an expansive definition, and includes more than what would be considered inventory items in, as an example, a typical retail business. We therefore disagree with the revenue agent's conclusion in this respect.

Issue 2

The relationship between I.R.C. §§ 351 and 751 when partnership interests are exchanged for stock in incorporation transactions was analyzed in depth in G.C.M. 37540 (May 18, 1978) (copy attached). (G.C.M. 37540 is one of several G.C.M.'s underlying Rev. Rul. 84-111, 1984-2 C.B. 88. Rev. Rul. 84-111 does not address a factual situation that is similar to yours.) As a starting point, it must be noted that I.R.C. §§ 351 and 751 deal with the federal income tax consequences at the shareholder/incorporator and exchanging partner levels, respectively. In analyzing the relationship between these two Code sections, the G.C.M. notes that by the nature of the plain language of the statutes themselves, I.R.C. § 351(a) is a nonrecognition provision which should supersede the realization provision of I.R.C. § 751. The G.C.M. also notes that Treas. Reg. § 1.741-1(c) cross references to I.R.C. § 351 "for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferror", and that because I.R.C. §§ 741 and 751 work in conjunction with each other, this cross reference is authority for the proposition that I.R.C. § 351(a) generally overrides I.R.C. § 751. Finally, the G.C.M. cites to Hempt Bros. Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974) (I.R.C. § 351 overrides the assignment of income doctrine), and concludes that because I.R.C. § 751 is a statutory attempt to apply the assignment of income principles to partnerships, Hempt Bros. is authority for concluding that I.R.C. § 351(a) overrides I.R.C. § 751. Thus, as a shareholder/incorporator and exchanging partner, gain will be recognized upon the exchange of a partnership interest for stock in a newly formed corporation, if at all, under the provisions of I.R.C. § 351(b) (governing the treatment of "boot" in incorporation transactions). See also G.C.M. 37551 (May 26, 1978).

However, once it is determined that there is a gain to be recognized under I.R.C. § 351(b), the rationale of G.C.M. 37540 is no longer applicable. Because there is gain to be recognized, there is no apparent reason why part or all of the recognized gain cannot be recharacterized under I.R.C. 751 in those cases where the underlying partnership assets consist of hot property. Thus, in the facts of your situation, because the taxpayers have conceded that the transferor partners (limited and general) recognized boot in the amount of $[redacted], I.R.C. § 751 will operate to characterize this recognized gain as ordinary income to the extent of the hot property held by the Partnership. Because most, if not all, of the Partnership's assets are hot property items, most if not all, of the gain recognized under I.R.C. § 351(b) should be characterized as ordinary income.

The recognition of their gain and its characterization as ordinary income is not governed by I.R.C §§ 731 and 751, as set forth in the FPAA. As more fully discussed under Issue 3, infra, I.R.C. § 731 is applicable to distributions from partnerships and not to exchanges of partnership interests. The more appropriate governing Code sections are I.R.C. §§ 741 and 751 in conjunction with the operative rules of I.R.C. § 351(b). Therefore, as to the exchanging partners, the FPAA is technically incorrect on this point.

Additionally, we note in passing that the exchanging partners were required to satisfy certain compliance requirements when filing their respective federal income tax returns for [redacted] under Treas. Reg. § 1.751-1(a)(3).

Issue 3

The FPAA states that the Partnership must recognize gain under I.R.C §§ 731 and 751 as a result of its technical termination because of the presence of the unrealized receivables in the Partnership on the date of termination, [redacted]. As noted above, I.R.C. § 731 would not be an applicable governing Code section with respect to the exchanging partners, but would be controlling as to the new and remaining partners. As discussed in depth below, we disagree with any potential conclusion that the application of I.R.C. § 751, at least as to the issues as they are presently framed, could result in gain recognition to the new and remaining partners.

Because of the technical termination of the Partnership under I.R.C. § 708(b)(1)(B), there is a deemed distribution of the Partnership properties to the new and remaining partners in proportion to their respective interests in the Partnership properties, followed by a recontribution of those properties to a "new" Partnership for purpose of continuing the business of the Partnership. See Treas. Reg. § 1.708-1(b)(1)(iv). The deemed distribution will be governed by the provisions of I.R.C. § 731. I.R.C. § 731(a) provides that, in part, in the case of a distribution (e.g., in liquidation) by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.1/ I.R.C. § 731(b) provides that no gain or loss be recognized to a partnership on a distribution to a partner of property, including money. However, I.R.C. § 731(c) provides, in part, that I.R.C. § 731, (i.e., nonrecognition of gain or limited gain recognition) will not apply to the extent otherwise provided by I.R.C. § 751.

As noted earlier in connection with our analysis as to Issue 2, I.R.C. § 751(a) is applicable to exchanges of partnership interests. Because a technical termination of a partnership under I.R.C. § 708(b)(1)(B) results in deemed liquidating distributions, and not exchanges, the reference in I.R.C. § 731(c) to I.R.C. § 751 refers specifically to the disproportionate distribution rules of I.R.C. § 751(b). I.R.C. § 751(a) would be inapplicable upon a technical termination under I.R.C. § 708(b)(1)(B). See Treas. Reg. § 1.732-1(b).

The disproportionate distribution rules of I.R.C. § 751(b) basically provide that if a partner receives a distribution of partnership property that results in that partner receiving anything but his proportionate share of the partnership's hot property, the transaction will be treated as a sale or exchange of such property between the partners and the partnership. In citing to the regulations under I.R.C. § 708, supra, we emphasized the proportionality language regarding the deemed liquidating distribution upon the technical termination of a partnership. Because the deemed liquidating distribution upon the technical termination of the Partnership is proportional, the disproportional distribution rules of I.R.C. § 751(b) are not applicable. And because the deemed liquidation is not an exchange within the meaning of I.R.C. §§ 741 and 751(a), I.R.C. § 751 is not applicable to the Partnership's liquidating distributions under I.R.C. § 731. Therefore, the only gain to be recognized by the new and remaining partners would be under the provisions of I.R.C. § 731(a), i.e., to the extent that any money distributed exceeds the adjusted basis of a partner's interest in the Partnership immediately before the distribution.

Issue 4

Given our analysis above, as the issues are presently framed, it would appear that the manner, method and amount of calculating the gain as set forth in the Partnership's submission

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1/ Because we are focusing on gain, we have not focused on or analyzed the potential consequences with respect to losses on such distributions.

dated [redacted], is the correct starting point for determining the gain as to the exchanging partners. The agent's explanation received by us on March 8, 1991, apparently concedes this point. We also agree with that portion of the taxpayer's submission that cautions against arbitrarily picking the book/tax differential as a starting point (or finishing point) for determining the amount of potential gain to be recognized. If the [redacted] adjustments discussed herein are to be pursued to their fullest extent, an independent analysis of adjusted bases and fair market values should be made.

To the extent the exchanging partners are required to recognize gain under I.R.C. § 351(b), any gain recognized will first be considered as ordinary income to the extent attributable to each partner's respective share of the hot property of the Partnership, with any remaining recognized being capital in nature. See Treas. Reg. § 1.751-1(a)(1). This ordering process prevents artificial manipulation of the applicable characterization provisions.

Issue 5

One possible additional avenue for attacking the transaction is to attack the viability of the I.R.C. § 351 transaction. If the transfers of the Partnership interests in exchange for the stock of the newly formed corporation failed to qualify for nonrecognition treatment under I.R.C. § 351, the exchange then becomes a taxable exchange as to the exchanging limited partners/shareholders. This is because the rationale and conclusion of G.C.M. 37540, supra, would not apply because of the taxable nature of the exchange transaction. I.R.C. § 751 could then operate to recharacterize any gain recognized on the exchange into ordinary income.

There are several potential theories that could be used to attack the incorporation transaction. First, it has long been a position of the Service that incorporation transactions under I.R.C. § 351 must be undertaken for a valid business purpose or purposes. See, e.g., Rev. Rul. 55-36, 1955-1 C.B. 340, and Rev. Rul. 70-140, 1970-1 C.B. 73; see also Gregory v. Helvering, 293 U.S. 465 (1935). If the incorporation transaction was not undertaken for a valid business purpose, the exchange becomes a taxable one. What is or is not a valid business purpose under any given set of facts and circumstances is factual in nature. However, if the only reason for the incorporation is tax deferraland/or recharacterization, the business purpose requirement could hardly be said to have been met. <u>See</u> <u>Gregory</u>, <u>supra</u>.

Because incorporation transactions under I.R.C. § 351 are tax free only when the business that is being incorporated is intended to be continued indefinitely, intact and in corporate form, if the incorporation was intended to be an interim step in selling the Partnership assets, the principles and policy for permitting tax free incorporations have not been met. Thus, attacks in the nature of tax avoidance, lack of substance, or a step transaction analysis could be used to pierce the tax free nature of the transaction. <u>See</u>, <u>e.g.</u>, <u>Griffiths v. Helvering</u>, 308 U.S. 355 (1939), <u>Noonan v. Commissioner</u>, 52 T.C. 907 (1969), <u>aff'd</u>, 451 F.2d 992 (9th Cir. 1971), and <u>West Coast Marketing Corporation v. Commissioner</u>, 46 T.C. 32 (1966).

Additionally, although it may present tougher battles to fight, traditional assignment of income principles and I.R.C. § 482 could conceivably be utilized to challenge the incorporation transaction, either alone or in conjunction with one or more of the arguments discussed above.

Because the information supplied to us concerning the incorporation transaction and its subsequent history is not complete, we cannot state with more certainty whether the theories briefly outlined above could be successfully applied to the incorporation transaction at issue. We are available to lend further assistance as developments occur.

We recognize that attacking the tax free nature of the incorporation transaction is an issue that is not covered by the FPAA, and would be considered a new issue if formally and properly raised at this time. Even though this issue is a "secondary position", if it is to be put forward, it should be raised at the earliest opportunity.

We caution that to the extent that one or more of the general partners may fall into both categories of partners described above, your analysis as to those partners would have to take such dual status into account.

If you have any questions regarding our analysis, do not hesitate to contact Thomas J. Kane at FTS 343-0032.

CURTIS G. WILSON
Chief,
Tax Shelter/Partnerships Branch

Attachment:
GCM 37540